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Nos. 974-976

In the Supreme Court of the United States

OCTOBER TERM, 1919

THE UNITED STATES OF AMERICA, PETITIONER

v.

JAMES M. RAGEN, SR., ARNOLD W. KRUSE, AND
LESTER A. KRUSE

PETITION FOR WRITS OF CERTIORARI TO THE UNITED
STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH
CIRCUIT

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The Solicitor General, on behalf of the United States prays that a writ of certiorari issue to review the judgments of the Circuit Court of Appeals for the Seventh Circuit, entered February 26, 1941 (R. 506-507), reversing the convictions of the three named respondents under Section 145 (b) of the Revenue Acts of 1932, 1934, and 1936 and Section 88 of Title 18 of the United States Code.

OPINIONS BELOW

The opinions of the United States Circuit Court of Appeals for the Seventh Circuit (R. 487-505) are unreported.

(1)

JURISDICTION

The judgments of the Circuit Court of Appeals were entered February 26, 1941 (R. 505-507). A petition for rehearing was denied March 18, 1941 (R. 507). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925, and the Rules of Practice and Procedure in Criminal Cases, promulgated by this Court.

QUESTIONS PRESENTED

The respondents were convicted of a wilful evasion of income taxes of a corporation by making payments under the guise of commissions for services which were in fact distributions of profits. The principal question presented is whether there is a sufficiently definite standard of guilt for the jury to convict if any services at all were rendered.¹

STATUTES AND REGULATIONS INVOLVED

The relevant provisions of the statutes and regulations involved are set forth in the Appendix, *infra*, pp. 16-17.

¹ As we read the opinion, this is the only question decided by the court below on this branch of the case. But, as a precautionary measure, we note the following additional questions which may be presented by the decision below: (1) Whether there was substantial evidence to support the verdict of the jury. (2) Whether all of the tax evasion charged by the indictment, or only a substantial portion, need be proved in order to convict. (3) Whether the trial judge properly instructed the jury. (4) Whether there was a fatal variance between the indictment, or the Government's theory of the case, and the proof.

STATEMENT

On August 22, 1939, an indictment in five counts was returned against the defendants and others in the District Court for the Northern District of Illinois, Eastern Division (R. 2-27). The first four counts charged wilful attempts to defeat and evade income taxes of the Consensus Publishing Company, a corporation, for the years 1933 through 1936, and the fifth conspiracy to commit such offenses for the years 1929 through 1936 (R. 2-27). The jury returned a verdict finding each of the defendants guilty on all five counts, except Lester Kruse, who was found guilty on the fourth and fifth counts (R. 237-238). Arnold Kruse was sentenced to eighteen months imprisonment and a \$10,000 fine; William Molasky and James Ragen each to a \$10,000 fine with imprisonment of a year and a day for Ragen, and a year for Molasky; and James Ragen, Jr., and Lester Kruse, the son of Arnold Kruse, each to fines of \$1,000 (R. 239-245).² On appeal to the Circuit Court of Appeals for the Seventh Circuit, the convictions were reversed (R. 505-507). The Government's petition for rehearing was denied on March 18, 1941 (R. 507).

Various preliminary motions and pleas were filed by the defendants which were overruled or denied by the District Court. The Circuit Court of Appeals, however, held that the District Court

² The corporation also was convicted and fined (R. 237, 245), but took no appeal.

erred in dismissing special immunity pleas in bar filed by William Molasky and James Ragen, Jr. (R. 491-496). The Government does not request that this ruling of the Circuit Court of Appeals, which affects only William Molasky and James Ragen, Jr., be reviewed by this Court.

The first four counts of the indictment (R. 2-18) charge severally that for the taxable years 1933 through 1936 the defendants wilfully caused the Consensus Publishing Company to file income tax returns which were false and fraudulent in that the returns deducted from the gross income of Consensus certain amounts designated as "commissions".⁵ The fifth count charges a conspiracy to file correspondingly false returns for the years 1929 through 1936 (R. 18-27). The evidence supporting the verdict of the jury may be summarized as follows:

The Consensus Publishing Company, the taxpayer corporation, was organized in 1929 (R. 334, 373), pursuant to an agreement between Moses Annenberg, Arnold Kruse, Ragen, Sr., and Molasky, for the purpose of carrying on the business of printing and selling "run-down sheets" to bookmakers (R. 323). These sheets were printed and distributed daily, showing the horses running at the different race tracks throughout the country

⁵ The amounts of these deductions for commissions were as follows: 1933, \$54,537.65 (R. 6); 1934, \$60,172.23 (R. 10); 1935, \$76,713.75 (R. 14); 1936, \$119,755.78 (R. 18).

with their post positions and code numbers for deciphering the wire service (R. 393). The evidence shows and the court below found that the 100 shares of stock of the company were first issued to dummies, with the exception of thirty shares which were issued to Molasky (R. 497). While the defendants contend that they were not stockholders and that all the stock belonged to the Cecelia Investment Company, a holding company for Annenberg, the court below recognized that the record justifies the conclusion that the defendants were stockholders (R. 499). The shares of stock were divided as follows: Cecelia Investment Company, thirty shares; Molasky, thirty shares; Arnold Kruse, twenty shares; James Ragen, Sr., twenty shares * (R. 333-334, 384).

The principal business office of the company was in St. Louis, Missouri, and from that office each week was sent to the Chicago offices of the Annenberg companies, which operated under the supervision of Arnold Kruse, reports of all the receipts and expenses of the business, showing the balance of profits remaining after the deduction of expenses (R. 322, 351). The bookkeeper who re-

* Thirty shares originally were issued to Molasky, of which fifteen shares were subsequently transferred to his niece, B. Hoffman (R. 334, 375, 497, 499). Twenty shares originally were issued to A. W. Kruse in the name of Clark and held by Kruse, the distributions thereon being assigned to his wife and son, Lester Kruse (R. 334, 377, 497, 499). Twenty shares were issued to J. M. Ragen and in 1931 were transferred to J. M. Ragen, Jr. (R. 334, 376, 499).

ceived these reports constructed his own work sheets on which he computed the receipts, expenses, net profits and the distribution of those profits (R. 414). Reports showing this information were sent to the stockholders each week (R. 334). The book-keeping system was set up as directed by Arnold Kruse (R. 410, 411, 416).

The net profits of the business were distributed in proportion to the stockholdings (R. 324, 340-341, 358-359). The defendants contend, however, that Cecelia alone received dividends, the rest receiving the remainder of the net profits, or 70%, not as dividends but as commissions for services. The books of the company showed these distributions as commissions, as they would have to if they were to be taken as a deduction for business expense (R. 327, 330). This was in accordance with instructions from Kruse, who told the bookkeepers to charge the net profits of the company amounting to 70% as commissions (R. 411). There is, however, much evidence that the payments were distributions of profits. Some of the bookkeepers' private work sheets showed distributions of "dividends" rather than "commissions" (R. 329-330, 337, 412). Until June, 1933, when the designation was changed to "dividends and commissions," the weekly private reports to the stockholders labeled these distributions as dividends (R. 330, 337). Molasky and his niece reported these distributions as dividends in their tax returns for the years 1933 through 1935

(R. 398 and Ex. 47-53). Kruse advised the bookkeeper that the division between the stockholders was an arbitrary arrangement (R. 342-344).

In 1934, Kruse, becoming concerned about a Board of Tax Appeals decision holding that distributions of profits as commissions but in accordance with stockholdings would not be allowed as a deductible expense (R. 393, 397), instructed an employee to destroy the original stock book of the company and to issue one certificate representing all the capital stock to Cecelia (R. 374-375). This was done, but the original certificates were retained by the stockholders until 1938, when they were carefully torn up or otherwise destroyed (R. 384-385). In 1936, Kruse instructed an employee to draw up written contracts of employment between the company and the individuals in whose name the profits of the company had been distributed (R. 381-384). Purported employment contracts were drawn and dated back over all the years to and including 1930, and were signed in bulk by the individuals (R. 399, 400, 403, 404, 407). The court below, while failing to see their relevance to income tax evasion, recognized that these transactions "strongly indicate that some sort of chicanery was in progress" (R. 501).

The court below stated (R. 500) that there was "considerable testimony in the record of services rendered by Molasky, who was president of Consensus, as well as by Kruse, Sr., and some evidence

of services performed by the other defendants." Molasky and Arnold Kruse undoubtedly did perform some services (R. 322-323, 326, 341, 354-355). But there is also evidence that little or no services were performed by the other defendants (R. 341, 353, 355). The witness Burris, who did bookkeeping work for Consensus for two years, testified that he had no knowledge of any work that Lester Kruse, or Ragen, Sr., or Ragen, Jr., ever did for Consensus (R. 341, 344). The bookkeeper Brooks similarly stated that, although he had talked to them over the telephone, he did not know any of the men and had never seen them in the office of Consensus (R. 353, 355).

None of the defendants testified or offered any testimony in his own behalf.

The court charged the jury in part as follows (R. 470-471):

If, on the other hand, if they were intended to and represented actual bona fide compensation to employees of this corporation in the ordinary operation of its business; in other words, if they were ordinary and necessary expenses of the operation of the business, then they were properly deductible as they

The only exception taken to this charge was as follows (R. 473):

"I take exception to the doctrine announced that if they find that this tax, or any substantial part thereof, was evaded or attempted to be evaded, that they may find the defendants guilty."

were deducted and no tax was due upon them.

* * * * *

Men that work for corporations are entitled to proper compensation, whether they be stockholders, directors or officers. They are entitled to reasonable compensation for such services as they may render, irrespective of their official connection with the corporation. On the other hand, shareholders are entitled to a division of the profits of the corporation in the way of dividends and it is for you to decide whether these were, or whether a substantial portion thereof, was a distribution of profits rather than the compensation of employees.

I use the words, "These sums or a substantial portion thereof." It is not necessary for the government under this indictment to prove that all of the sums so distributed to these defendants were profits. It is not necessary that the government prove all of the figures precisely as they are charged in the indictment. It is sufficient if you find beyond a reasonable doubt that the defendants intentionally diverted profits of this concern, in the amounts charged in the indictment or substantial parts thereof, diverted them from the form of profits and received them in the form of commissions.

REASONS FOR GRANTING THE WRIT

The single issue before the trial court and the court below was whether the defendants wilfully

attempted and conspired to evade and defeat in any manner the income taxes of the Consensus Publishing Company in violation of Section 145 (b). This was a simple issue of fact resolved beyond a reasonable doubt by the jury's verdict. The majority opinion of the court below, however, contains an elaborate narration of the evidence (R. 497-502). It undertakes to cast a balance between the conflicting inferences, approving some of the Government's contentions (R. 499) and rather more of the respondents' (R. 500-502). The plain inference of this otherwise irrelevant discussion is that the court reversed because it did not think the evidence sufficient to support the verdict. Had it in fact done so, in the face of the considerable and substantial evidence supporting the verdict, it would have been guilty of a flagrant invasion of the province of the jury. But it nowhere makes any such ruling, and indeed asserts that its review of the evidence was only to insure that respondents had a fair trial (R. 499). We do not understand that we can assign error to a gratuitous and rather one-sided narration of evidence, nor object that the differences of opinion between the majority of the court below and the jury on matters of fact doubtless colored its specific rulings of law (cf. R. 503).

The court below, however, ruled in terms (R. 502) that "where a statute permits a reasonable deduction for services, a criminal prosecution cannot be maintained by proof other than that such serv-

ices were not rendered." In its opinion, proof that any compensable services were rendered requires a directed verdict (R. 502, 503). Otherwise, it declared, there is left to each trier of the facts the responsibility of determining a standard for reasonable deductions and this, under the doctrine of *United States v. Coken Grocery Co.*, 255 U. S. 81, violates the constitutional rights of the accused.⁶ This decision seems plainly wrong, conflicts in principle with decisions of this Court, and constitutes a significant threat to the enforcement of the revenue laws.

1. The court below assumed that prosecution and conviction would be possible, under the Government's theory, if only there were proof sufficient to convince the jury that any given deduction was unreasonable (R. 502-504). It proceeded in complete disregard of the fact that the statute requires also that there be a *wilful* attempt at evasion (Sec.

⁶ Apparently in consequence of its views on the constitutional question, the court below held erroneous the charge of the trial court that the jury could convict if it found that any substantial portion of the payments was a distribution of profits (R. 503-504). But, it may be observed, the charge was also entirely proper under the court's own theory, for the jury might have found that in some years one or more defendants rendered no services at all, or that as to some of the defendants some or all the payments were profits in their entirety. If any of the payments were dividends, a fraudulent redaction of tax automatically resulted. The Government is not required to prove an evasion of all the tax charged. *Gleckman v. United States*, 80 F. (2d) 394 (C. C. A. 8th), certiorari denied, 297 U. S. 709.

'45 (b), Revenue Act of 1932, *infra*).⁷ This requirement affords full protection for the innocent and removes all ground for constitutional attack because of indefiniteness. *Gorin v. United States*, Nos. 87-88, this Term, decided January 13, 1941; *Omacchevarria v. Idaho*, 246 U. S. 343, 348; *Hysgrade Provision Co. v. Sherman*, 266 U. S. 497, 501. The contrary ruling of the court below is in substantial conflict with the *Gorin* case, where this Court relied upon the "obvious delimiting words in the statute" requiring "intent or reason to believe."

In *United States v. Kelley*, 105 F. (2d) 912 (C. C. A. 2d), the Court affirmed a conviction of income tax evasion in which the items receiving the chief emphasis related to deductions for depreciation and bad debts. Judge Learned Hand found, with respect to depreciation, that "The padding was both in the number of items contained * * * and in their value." While some of the items were fabricated, the vice in other entries related simply to overvaluation (p. 915). We do not see that the *Kelley* opinion can in this regard be reconciled with the theory of the court below. See also *In re Zimmerman*, 108 F. (2d) 370 (C. C. A. 7th).

2. The question is one of substantial importance in the enforcement of the revenue laws. The court

⁷ The indictment alleges (R. 3, 5, et seq.), that the attempted evasion was wilful and the trial court in its charge required (R. 472) that the jury find the evasion wilful. There was much evidence to show that the evasion was wilful. See Statement, *supra*, pp. 6-7.

below has passed over the requirement of Section 145 (b) that there be wilful evasion and has instead viewed the prosecution as based upon Section 23 (a), permitting deduction of reasonable business expenses. Its decision means that any deduction, so long as it is made under a provision which permits a reasonable deduction, is immune from prosecution, no matter how great the fraud, if only some proportion of the deduction can be shown to be legitimate. The decision below reads an important and wholly unwarranted limitation into Section 145 (b), in which Congress provided for the punishment of "any person who wilfully attempts *in any manner* to evade or defeat any tax."

Many provisions of the income-tax laws require or permit adjustments in gross income or in deduc-

* The following sections of the Internal Revenue Code (53 Stat.) are illustrative: Sec. 23 (a) (1), "All the ordinary and necessary [business] expenses * * * including a reasonable allowance for salaries"; Sec. 23 (k) (1), "Debts ascertained to be worthless"; Sec. 23 (l), "A reasonable allowance" for depreciation and obsolescence; Sec. 23 (m), "a reasonable allowance for depletion"; Sec. 23 (p) (1), "a reasonable amount transferred" to a pension trust; Sec. 25 (a) (4) (A), "a reasonable allowance" for the taxpayer's personal services; Sec. 27 (a) (4), "reasonable" amounts set aside to retire indebtedness; Sec. 27 (d), (e), (f), "fair market value"; Sec. 101 (4), building and loan associations "substantially all the business of which is confined" to membership loans; Sec. 101 (6), organizations "no substantial part of the activities of which is carrying on propaganda"; Sec. 101 (12), agricultural cooperatives "if substantially all" their stock is owned by producers; Sec. 102

tions which are not capable of mathematical calculation.' Under the decision of the court below, for example, it would seem that none could be convicted of a wilful evasion of income taxes so long as he showed that his property had suffered *any* depreciation, or so long as he could show that he had incurred *any* business expense of the challenged type. Tax returns of necessity involve judgment as well as mathematical computations. Because men may differ on the matters of judgment affords no protection to those who wilfully make false returns. Any other rule would make the revenue acts the sport of any knave subtle enough to perpetrate his fraud through exaggeration and distortion rather than through reports of wholly imaginary transactions.

The Department in its prosecution policy has not considered that wilful tax evasion was exempt simply because tax items were involved as to

(a), corporations "formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders"; Sec. 102 (c), earnings "permitted to accumulate beyond the reasonable needs of the business"; Sec. 105, oil and gas properties "the principal value of" which has been demonstrated by the taxpayer's exploration; Sec. 112 (b) (1), "property held for productive use in trade or business or for investment (not * * * held primarily for sale * * *)"; Sec. 113 (b) (1), "Proper adjustment" for expenditures, depreciation, etc.; Sec. 119 (b), "expenses, losses, and other deductions properly apportioned or allocated" to income from within the United States; Secs. 166 and 167, "substantial adverse interest" in the disposition of the trust or its income.

which honest men might differ. Under the decision below, it would appear that none may be convicted so long as any part of the deduction was legitimate. This is a restriction upon the enforcement of the revenue acts so serious as to warrant the review of this Court.⁹

CONCLUSION

It is therefore respectfully submitted that this petition for a writ of certiorari should be granted.

✓ CHARLES FAHY,
Acting Solicitor General.

APRIL, 1941.

⁹ The court below suggested, but did not in terms rule, that its theory was justified by the form of the indictment and the theory upon which the case was tried (R. 502, 503-504). This is not the case. Count 5 of the indictment, it is true, alleges that none of the defendants performed any services for Consensus (R. 23), while the proof showed that some of the defendants did perform services. But the respondents were under no misapprehension as to the charge against them, which was distributing profits in the guise of salaries and commissions. The variance accordingly was immaterial. See *Berger v. United States*, 295 U. S. 78; *Bennett v. United States*, 227 U. S. 333. The theory of the Government's case was that it was immaterial whether or not services were rendered; if profits were distributed as dividends to stockholders the fraud was no less because some of the stockholders may have rendered services to Consensus. There is nothing inconsistent with this theory in a conviction under a charge that the defendants were guilty if a substantial proportion of the payments in fact represented profits.

APPENDIX

Revenue Act of 1932, c. 209, 47 Stat. 169:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) *Expenses*.—All the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business, including a reasonable allowance for salaries or other compensation for personal services actually rendered; * * *

SEC. 145. PENALTIES.

* * * * *

(b) Any person required under this title to collect, account for, and pay over any tax imposed by this title, who willfully fails to collect or truthfully account for and pay over such tax, and any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof, shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, be fined not more than \$10,000, or imprisoned for not more than five years, or both, together with the costs of prosecution.

Revenue Act of 1934, c. 277, 48 Stat. 680:

Section 23 (a) is identical with Section 23 (a) of the Revenue Act of 1932 above quoted. (U. S. C., Title 26, Sec. 23.)

Section 145 (b) is identical with Section 145 (b) of the Revenue Act of 1932 above quoted. (U. S. C., Title 26, Sec. 145.)

Revenue Act of 1936, c. 690, 49 Stat. 1648:

Section 23 (a) is identical with Section 23 (a) of the Revenue Act of 1932 above quoted.

Section 145 (b) is identical with Section 145 (b) of the Revenue Act of 1932 above quoted.

Treasury Regulations 77, promulgated under the Revenue Act of 1932:

ART. 126. *Compensation for personal services.*—Among the ordinary and necessary expenses paid or incurred in carrying on any trade or business may be included a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility in the case of compensation payments is whether they are reasonable and are in fact payments purely for services. * * *

Treasury Regulations 86, promulgated under the Revenue Act of 1934:

Article 23 (a)-6 is identical with Article 126 of Treasury Regulations 77 above quoted.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

Article 23 (a)-6 is identical with Article 126 of Treasury Regulations 77 above quoted.